Knox, John Jay

Reduction of the surplus

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REDUCTION OF THE SURPLUS.

BY JOHN JAY KNOX.

In an article upon "The Future of the National Banking System," published in the *North American Review* for January, the subject of the reduction of the surplus was briefly referred to. The proposition was to provide for the refunding of the four per cent. bonds, amounting to about 738 millions, into two-and-a-half per cents in all respects precisely like the fours except in the rate of interest, the Government offering to the holders of the fours the inducement to exchange the old bonds for the new by paying in advance the difference in interest between two-and-a-half per cent. and four per cent. as calculated by the Actuary of the Treasury Department. Since the publication of that article I have received from the Actuary of the Treasury of the United States the following letter, giving an exact calculation of the difference to be paid to the holders of the four per cents in money. It is as follows:

UNITED STATES TREASURY DEPARTMENT,
WASHINGTON, D. C., December 24, 1886.

John Jay Knox, Esq., President National Bank of the Republic, New York.

MY DEAR SIR:—In response to your request of the 11th inst. as to "the difference in interest between 738 millions of 4 per cents maturing in 1907 and a bond exactly the same, maturing at the same date, bearing interest at 2½ per cent." I would say that, throwing out of consideration the superior advantages offered by the 2½ per cent. bond for the purposes of bank-note circulation, the present value to the holders of one dollar and a half a year for 20 years, re-invested quarterly, is, if computed at a 4 per cent. rate of investment, $20.5831; if invested at 3 per cent., $22.4979; and, if invested at 5 per cent., $18.895 on each $100 bond.

Very truly yours, E. B. ELLIOTT, *Government Actuary.*

MEMORANDUM.

Present value of one dollar and a half a year for 20 years, re-invested quarterly, at the following rates of interest per annum.		*Corresponding difference in interest on $738,000,000 reduced from 4 per cent. to 2½ per cent. per annum.*
2½ per cent	$23.552	$173,810,000
3 per cent	22.498	166,034,000
4 per cent	20.583	151,903,000
5 per cent	18.895	139,445,000

According to this calculation, the holder of $100,000 of four per cent. bonds would receive new two-and-a-halfs, maturing at the same date as the fours, and in addition $23,552 cash, if the rate of interest upon the interest advanced by the Government is cast at two-and-a-half per cent., or at a little above the borrowing power of the Government.

If the rate of interest is cast at four per cent. the holder of $100,000 of bonds would receive new two-and-a-half per cents and $20,583 cash.

I have conversed with many large holders of the four per cents, including officers of banks and trust companies and other corporations, and all of them, without exception, have expressed the opinion that if such an offer was made the four per cents would be readily returned to the Government, either for conversion or for reduction in the rate of interest by stamping on the four per cents as proposed in the bill introduced in the House by Hon. Abram S. Hewitt, of New York.

Private individuals who are satisfied with a small income hold Government bonds for the purpose of avoiding taxation; National banks hold them

as security for circulating notes and for Government deposits; savings banks and trust companies hold them as a reserve and because they are not subject to taxation; and insurance companies and other corporations are required by law to deposit them with State authorities. It is evident that a bond having a low rate of interest, payable at the same time as the fours, could be used equally as well for any or all of these purposes.

The bill of Senator Aldrich, now pending in the Senate, provides: "That the two-and-one-half per centum bonds herein authorized, issued in exchange for four per centum bonds, shall not be called in and paid so long as any bonds of the United States heretofore issued, bearing a higher rate of interest, shall be outstanding and uncalled, and the last of such bonds originally issued under this Act, or the substitutes issued therefor, shall be first called in; and this order of payment shall be followed until all of such bonds shall have been called in or paid." The bill also authorizes the issue of circulation of National banks up to the par value of the two-and-a-halfs. Such legislation would immediately enhance the value of the two-and-a-halfs, and the holders of the fours, and particularly the National banks (who hold about 125 millions), would hasten to make the exchange in order to obtain the earliest numbers of the new bonds, for the same reason that similar exchanges were promptly made for the three-and-a-halfs, and subsequently for the threes at the time those bonds were issued.

The new two-and-a-halfs can also be made more valuable, and the proposed exchange rendered certain, by extending the date of the maturity of a portion of the new bonds to a date subsequent to 1907, when the present bonds are payable.

Under the present law the whole 738 millions of fours mature on July 1, 1907 The Government cannot, of course, at that time pay the whole amount, and will undoubtedly, at the maturity of these bonds, extend the time of payment by reducing the rate, as it did at the date of the maturity of the five and six per cents on July 1, 1881, when 579 millions of these bonds were extended or continued at the rate of three and a half per cent.; or, as it did two years subsequently, on July 1, 1883, when more than 300 millions of three-and-a-halfs were continued at the rate of three per cent.

The bill of Senator Aldrich can be so amended that the date of the payment of the new two-and-a-halfs to be issued may be postponed, at the same rate of interest, beyond the maturity of the fours, and made payable in instalments of 100 millions, or less, annually during each year succeeding July 1, 1907, until the whole amount is paid, as follows:*

Rate of Interest.	*Maturity of Bonds.*	*Amount.*
2½ per cent	July 1, 1907.	$100,000,000.
2½ per cent	July 1, 1908.	100,000,000.
2½ per cent	July 1, 1909.	100,000,000.
2½ per cent	July 1, 1910.	100,000,000.
2½ per cent	July 1, 1911.	100,000,000.
2½ per cent	July 1, 1912.	100,000,000.
2½ per cent	July 1, 1913.	100,000,000.
2½ per cent	July 1, 1914.	100,000,000.
2½ per cent	July 1, 1915.	37,000,000.
		$837,900,000.

* There is a precedent for making bonds under the same law payable at different dates in the bonds issued by the Government to Pacific Railways, which mature at seven different dates, commencing January 16, 1895, and ending January 1, 1899.

Or, if the annual payments were fixed at 80 millions, then the final payment of 37 millions would be in the year 1917, ten years after the maturity of the present bonds. This would make the new two-and-a-half per cents exceedingly desirable to all holders of United States bonds, and particularly to that large class who desire the *longest* bonds. The holders of the four per cents first presenting their bonds for exchange would receive the new two-and-a-halfs having the longest time to run, and there is no doubt there would be a brisk competition among holders to obtain the longest bonds, which under the bill proposed would be the first bonds issued.

It has been proposed by Senator Beck, and by Representative Scott and others, to loan the surplus reserve, which is estimated by the Secretary of the Treasury to be 100 millions annually, temporarily at two per cent. to holders of Governments who would deposit such bonds as security. Even at this low rate of interest, upon the condition named, it is not believed that the Government would succeed in loaning any considerable amount of the surplus; but, if the Government will offer to the holders of the fours the inducements which are here outlined, it may not only refund all of these bonds into the two-and-a-halfs—the lowest rate of interest of any Government—but may at the same time receive *four per cent. interest* upon the interest which it pays in advance to these bondholders. In other words, it may successfully reduce its surplus and complete the whole transaction by offering for every $100,000 of the fours the same amount of two-and-one-halfs and $20,583 cash.

According to the calculation of the Government Actuary, as given above in his letter, the just and equitable amount to be paid to the holders in advance as interest upon the 738 millions of fours for an exchange of such bonds for two-and-a-half per cents is $173,810,000 in cash.

With the additional inducement of an extension of the date of maturity of the new two-and-a-half per cents, there is no doubt that the whole transaction could be consummated by offering to the holders of the fours in the aggregate $151,903,000, thus effecting a gain to the Government in the whole transaction of $21,907,000, and at the same time reducing the surplus during the next two or three years $151,903,000, according to the exact calculation of the Actuary of the Treasury Department.

This plan for refunding the last loan of the Government, if the proper legislation can be obtained, is perfectly feasible, and can be readily carried out, and would be unsurpassed even by the brilliant transactions of Secretary Sherman, when these very bonds, the four per cents, were issued in the year of the resumption of specie payments—1879.

The proposed plan will be of advantage to the bond-holder, and, owing to the existing circumstances, still more advantageous to the Government. It provides for the reduction of the surplus as rapidly as the state of the Treasury will warrant, and will give ample time for both parties to mature a bill for a just and permanent reduction of the customs duties.

END OF
TITLE